ently, meant to give its sanction to this correct practice. The word "sustained" alone would have covered an estimated depreciation, and the intent of Congress in adding the word "actually" must have been to require some charging off of depreciation or some payment into a depreciation fund. This is the construction given to the phrase "losses actually sustained" in *Baldwin's Locomotive Works* v. *McCoach,* 215 Fed. 967, 969; 221 Fed. 59, and the same meaning should be placed on the phrase "a reasonable allowance for depreciation."

In addition, the act, when dealing with the return, provides that the corporation shall state "separately any amounts allowed for depreciation of property." This "allowance" must, of course, be made by the company itself and not by the taxing officials, and the language seems to point to some actual things done by the corporation in regard to "depreciation" and not to a mere estimate.

(B) Depletion of capital can not be deducted as "depreciation."

It may be admitted that under certain circumstances the term "depreciation" might be given a meaning broad enough to cover depletion of capital, but it seems certain that this is not its ordinary natural meaning. If a loaf of bread is eaten, no person would say that it had "depreciated." If a merchant has a stock of goods and he sells some

while others are damaged or affected by change of fashion, he certainly would not call the processes by the same name. In the case of a coal mine we say that the machinery, shafts, etc., depreciate, but we do not say that the coal depreciates by being sold. The hardship of the case, if any, should not be met by calling the process of sale something which it is not, namely, " depreciation."

The English decisions all seem to maintain, or, at least, countenance the view that depletion of capital can not be deducted as depreciation. *Lee* v. *Neuchatel Asphalt Co.* 41 Ch. Div. 1; *Wilmer* v. *McNamara & Co. Ltd.* (1895), 2 Ch. 245; *Coltness Iron Co.* v. *Black,* 6 App. Cas. 315; *Alianza Co.* v. *Bell* (1904), 2 K. B. 666 (1905), 1 K. B. 184 (1906), A. C. 18; *Kauri Timber Co. Limited* v. *Commr. of Taxes* (1913), A. C. 771, 777. In the latter case the Privy Council said:

> With regard to the decided cases, *the general principle* as to the impropriety of treating a quota of invested capital, or of the corpus of the subject acquired, as a proper item of debit from annual profits received, can no longer be considered to be in doubt. [Italics ours.]

In *Earl of Derby* v. *Aylmer* (1915), 31 Times Law Rep. 528, the question was whether, under the language of the act of 1878, section 12, the Earl of Derby was entitled to a deduction on account of the diminished value of a stallion for breeding

purposes owing to his increasing age. In holding that he was not the court said:

> That the diminished value was on the same footing as the investment of money in a waning source of income.

It is true that these cases go to some extent upon the peculiar language of the acts involved, but they appear also to be largely based upon the general principle that a depletion of capital is not a proper item of debit in an income account. The matter was squarely ruled in the way we contend for under the Civil War income-tax acts by the Commissioner of Internal Revenue (Boutwell on the direct and excise tax system of the United States, pp. 273, 274), and apparently this ruling was never questioned. In the case of *Stratton's Independence* v. *Howbert*, 207 Fed. 419, 421, 422, Judge Pope said:

> The ordinary definition of " depreciation " is the lessening of value. As applied to mining properties the word carries with it, as in the case of any other business, the idea of deterioration in visible improvements, such as mills and other surface structures and perhaps the underground improvements so far as they are put in by the hand of man, and therefore, speaking popularly, when we think of depreciation in mining properties, we think of a lessening in value by time, or perhaps by accident, of those physical elements which go to develop and to improve the property. Now, does this meaning, com-

monly entertained and accepted and which is common to every class of corporations, become enlarged in case of mining companies so as to make the extraction of ore likewise an element of depreciation? The court's view is that it does not. This conclusion is in part induced by the reasons which have been above discussed in connection with the term " net income " and in part by the peculiar nature of the mining business. This latter is sui generis. It lives by dying. It is a business that is intrinsically uncertain. The segregation of part of a stock of goods is a definite detraction from the whole. The excavation of a body of ore, however, may reveal other bodies and result in immeasurable increment. The taking out of ore, while in a sense depreciation from the body, very often leads to the revealing of still larger bodies, and thus results, not in a lessening of the value of the claim, but in a great increase in such value. Mining excavation, when properly conducted, is very often more a development than a waste or a detraction. As applied to this class of corporation, having as its purpose to exhaust—it may be a year hence or a hundred years hence—the body of ore for profit, the mere fact that ore may be extracted does not in my judgment make the value of such ore an element to be classed and deducted as a depreciation of the property. The court therefore holds, as to this second provision of the statute, that the extraction of ore does not constitute a credit in favor of

mining companies upon the account between them and the Government when this excise tax is to be assessed.

This same principle seems to be recognized by the Supreme Court of Pennsylvania in *Commonwealth* v. *The Ocean Oil Co.*, 59 Pa. St. 61; *Commonwealth* v. *Penn Gas Coal Co.*, 62 Pa. St. 241; and by the Supreme Court of Wisconsin in a recent decision under the income-tax act of that State. *Van Dyke* v. *City of Milwaukee*, 159 Wis. 460. On the other hand, no authority has been called to our attention where depletion of capital has been treated as "depreciation," except the decision of the court below and the decision of Judge Lacombe in the *Nipissing Mines* case, 202 Fed. 803.

CONCLUSION.

The judgment of the court below should be reversed and the cases ordered remanded to the district court with directions to enter judgments for the defendants.

WILLIAM WALLACE, Jr.,
Assistant Attorney General.

NOVEMBER, 1916.

O

In the Supreme Court of the United States.

OCTOBER TERM, 1915.

Nos.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, petitioner,

v.

SARGENT LAND COMPANY, A CORPORATION.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, petitioner,

v.

SUTTON LAND COMPANY, A CORPORATION.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, petitioner,

v.

KEARSARGE LAND COMPANY, A CORPORATION.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT.

To the Supreme Court of the United States:

The Solicitor General, on behalf of the United States, prays for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Eighth Circuit in the above-entitled causes.

QUESTION PRESENTED.

The question presented is whether corporations, lessors in mining leases, are liable to pay a corporation tax on the royalties or rents received therefrom, under the provisions of section 38 of the act of Congress of August 5, 1909, 36 Stat. 11, 112.

THE FACTS.

At some early time the Pillsbury brothers became the owners of large tracts of land in Minnesota (R. 44). After removing the timber, they sold undivided interests in the land, with a view of developing its ore deposits, to Bennett and Longyear (R. 45). Subsequently, and prior to 1902, the undivided interests of the Pillsbury's passed, on their deaths, to their respective devisees, whose interests were, in some cases, as small as 216ths, and some of whom were minors (R. 45, 46). Under the laws of Minnesota a minor can not make a lease for more than 25 years (R. 46). As ore leases are usually made for a longer period, and as such small fractional interests embarrassed the efficient handling of the property, it was determined to form corporations, and to issue to the owners so much stock therein as would exactly represent the undivided interest of each (R. 47). Because the amount of land owned was in excess of what the laws of Minnesota permitted one corporation to own (R. 47), these three respondent corporations were formed about February 20,

1906 (R. 1, 13, 25). The original articles of each provided (R. 8):

> The general nature of its business shall be the buying, owning, exploring and developing, leasing, improving, selling and dealing in lands, tenements and hereditaments, and the doing of all things necessary or incidental to the things above specified.

This provision was amended December 29, 1909, to read (R. 3):

> "The general purpose of the corporation is to unite in one ownership the undivided fractional interests of its various stockholders in lands, tenements and hereditaments, and to own such property, and, for the convenience of its stockholders, to receive, and distribute among them the proceeds of any disposition of such property at such times, in such amounts, and in such manner, as the board of directors may determine."

Article X (after stating that the title to the property was in two classes (1) the heirs and devisees of the Pillsburys, and (2) Bennett and Longyear), recited (R. 10):

> this corporation having been formed, by mutual agreement of all said owners of both classes, for the more convenient handling, improvement, development and disposition of said properties * * *.

Prior to the organization of these corporations certain so-called mining leases had been made by the owners (R. 46), of which Plaintiff's Exhibit 15 is a

sample (R. 97, 98). Probably all the leases had been negotiated prior to the organization of the corporations (R. 50, 51), but one of the most important (Plaintiff's Ex. 16), was actually executed by the Sargent Land Company on January 2, 1907 (R. 50). These leases do not differ in any material respect from the ordinary form of mining lease used generally in this country. They "lease and demise" and "let and demise" certain lands for the purpose of exploring and taking out "the iron ore," "the merchantable iron ore" therein. One lease is for a term of 50 years, and the other is until all merchantable ore grading 49 per cent and upwards has been mined and shipped. In one lease the lessee agrees to pay "as rent or royalty" 25 cents a ton. In the other the lessee agrees to make graded payments of certain amounts per ton "as royalty." Both leases provide for minimum payments by the lessee in any event. Since the lessee is bound by elaborate stipulations to drill honestly for ore, to remove the ore in a proper manner, and to keep accurate accounts so that the royalty may be properly determined, the lessor reserves the right to enter on the land and drill for itself, also to inspect the workings; and the lessee is obligated to render daily and monthly statements as to the ore mined and the ore shipped. The leases contain the usual provisions as to the lessor's right to reenter and repossess on breach by the lessee of its agreements; they provide that tenants' fixtures shall not be removed, and a lien is reserved on the ore till it is sold.

The rights thus reserved to the lessor corporations they constantly exercised during the taxing years in question. They incorporated a company to inspect the operations of the lessees, and such inspections were regularly made (R. 55, 57–59). The controversy between the Kearsarge Land Company and the Oliver Mining Company, which appears on pages 77 to 80 of the record, is a fair example of the close attention and supervision given by these lessors to the operations of the lessees; and this was natural and necessary since the amount of their royalty depended on the extent to which, and the manner in which, the lessees mined the ore. In addition, the corporations did other things during the taxing years in question which space does not permit a rehearsal of. Their various activities are correctly set out by the district judge in his opinion (R. 115, 116).

After the passage of the Corporation Tax Act the corporations claimed that they were not liable thereto because they were not doing business, and had no income (R. 3). Being compelled to make a return, they filed one showing depreciation in excess of their gross income (R. 4, 5). The Government nevertheless assessed a tax upon them, the exact basis of which does not clearly appear in the record (R. 5, 107, 108). The record does show, however, that their claim for depreciation was based entirely on the annual depletion of capital from gradual waste of the ore supplies (R. 109), and that no actual allowance or charge for such so-called "depreciation" was ever made by them on their books of account (R. 49, 108).

bearing in mind the foregoing general principles, the weight of the reasoning is in favor of the construction we contend for. The strongest argument lies in the connection in which the term "depreciation" is found. The deduction permitted is:

> All losses *actually* sustained within the year * * * *including* a reasonable allowance for depreciation of property.

It seems clear, therefore, that "depreciation," as defined by the act, is within the class "losses *actually* sustained within the year"; and it seems equally clear that a loss to be "*actually* sustained" must have caused some actual disservice or damage to the person concerned. The mere depreciation of stocks on the exchange, of goods from damage, of a house from the weather, is not a loss "actually sustained" until in some way a payment has been made, or some analogous thing has been done which constitutes what is termed a "taking of the loss." Any other view will open the door to fraudulent or exaggerated estimates of losses by the taxpayer, and this is especially true of "depreciation." It is almost impossible to adopt any rule for *estimating* "depreciation" which shall apply to all businesses, and there is never any difficulty in obtaining the services of experts who will give as exaggerated an estimate of "depreciation" as the owner desires. As a matter of fact, most prudent business men do actually charge off annually a certain amount for "depreciation," and the act, appar-

122 Minn. 190. These decisions made a rule of property in Minnesota as to mining leases, which the Circuit Court of Appeals, under the decisions of this court, was bound to follow.

3. The decision of the Court of Appeals that the plaintiffs had no income, or were entitled to cancel it all by "depreciation," is contrary to the decision of this court in *Stratton's Independence, Limited*, v. *Howbert*, 231 U. S. 399.

4. The cases are of great public importance. Many suits are pending, or are about to be brought, to recover large amounts of taxes whose collection is claimed to be illegal for the same reasons asserted by the Circuit Court of Appeals in the present cases. Moreover, the same point will constantly arise under the Income Tax Act, for if, as held by the Circuit Court of Appeals, the corporations here had no income within the meaning of the Corporation Tax Act, equally individuals and corporations, lessors in mining leases, would have no income under the Income Tax Act, and the Government would be compelled to forego large amounts of taxes.

BRIEF IN SUPPORT OF THE PETITION.

I.

The respondents were "doing business" within the meaning of the Corporation Tax Act.

This depends on whether the cases fall within *Mitchell* v. *Clark Iron Co.*, 220 U. S. 107, 170, or within *United States* v. *Emery, Bird, Thayer Realty Co.*, 237 U. S. 28.

In *Mitchell* v. *Clark Iron Co.* the bill of complaint alleged that the company was incorporated under the laws of Minnesota (ch. 28, Laws 1876) and was authorized to own and hold real estate; that it was the owner of certain lands in Minnesota which it had explored for iron;

> That the defendant Clark Iron Company some years ago made explorations for iron ore upon the lands hereinbefore described, or some portion thereof, and caused explorations and developments to be made thereon, resulting in the discovery of large bodies of iron ore in said premises, or some portion thereof.
>
> *That for more than three years last past the said lands upon which such deposits of iron ore have been discovered, have been leased to other parties or corporations for the purpose of carrying on mining operations thereon and taking out and removing iron ore,* in consideration of the payment to the said defendant Clark Iron Company of rents or royalties based upon the iron ore so mined and removed, *and that for more than three years last past the said defendant Clark Iron Company has not engaged in any business other than to watch over and care for the said lands and receive the rents and royalties accruing therefrom and distribute the same to its stockholders by means of dividends,* except such business as has been necessary to transact in defending its title to the said premises, in which the said defendant has incurred large expense, the amount of which is unknown to this plaintiff,

> and that the only income the said defendant company has had for more than three years last past has been by way of rent and revenue from the said lands, accruing by and thru the leasing thereof for iron mining purposes by way of rental paid by the lessees on a royalty basis upon the iron ore mined and removed from said lands. [Italics ours.]

The case was tried on demurrer, so that these were the only facts before the court. This court, after stating these facts as to the nature of the business done by the company, said (220 U. S. 171):

> We think it is clear that corporations organized for the purpose of doing business, and actually engaged in such activities as leasing property, collecting rents, managing office buildings, making investments of profits, *or leasing ore lands and collecting royalties,* managing wharves, dividing profits, and in some cases investing the surplus, are engaged in business within the meaning of this statute, and in the capacity necessary to make such organizations subject to the law. [Italics ours.]

In the *Emery, Bird, Thayer Realty Company* case this court said (237 U. S. 32, 33):

> * * * The question is rather what the corporation is doing than what it could do, 228 U. S. 305, 306, but looking even to its powers they are limited very nearly to the necessary incidents of holding a specific tract of land. The possible sale of the whole would be merely the winding up of the corporation. That of a part would signify that the Dry

> Goods Company did not need it. *The claimants' characteristic charter function and the only one that it was carrying on was the bare receipt and distribution to its stockholders of rent from a specified parcel of land. Unless its bare existence as an intermediary was doing business, it is hard to imagine how it could be less engaged.* [Italics ours.]

It is submitted that the cases at bar fall directly within *Mitchell* v. *Clark Iron Company*. In that case, as stated above, it was alleged that all the leases had been made more than three years prior to the filing of the complaint, February 10, 1910, so that since the passage of the Corporation Tax Act the company had done nothing but watch over its lands, and collect its royalties. That case is decisive here.

In the *Emery, Bird, Thayer Realty Company* case, while it is true that the corporation was carrying out the functions for which it was incorporated, those functions were purely passive. The corporation was a mere conduit pipe. It was as though it had been incorporated merely to collect the interest on investments, to receive income, so that it could be reached, not by an excise, but only by an income, tax. In the cases at bar, the companies were incorporated for the very purpose of getting, in the operation and management of mining leases, the advantage of a legal person over minors and undivided interests. The corporations supplied the main capital—the land. The lessees supplied the labor and, so to speak, the working capital. The product was divided between them. This arrangement constituted a community

of interest between lessors and lessees, and required the corporations to do what they did, namely, exercise a constant supervision over the business to see that they obtained their just royalties. This is fully brought out in the opinion of the district judge (R. 115–117), and it seems impossible to add anything thereto.

II.

A mining lease is not a sale on installments, and the royalties thereon are income.

(*a*) The Circuit Court of Appeals in deciding that a mining lease was a sale relied entirely upon a remark of Lord Blackburn in *Coltness Iron Co.* v. *Black*, 6 App. Cas., 315, 335, and on certain Pennsylvania cases (219 Fed. 38, 39). But Lord Blackburn concluded the remarks quoted, as follows:

> But the argument that no income tax should be imposed on what is, perhaps not quite accurately, called rent reserved on a mineral lease, because it is a payment by instalments of the price of minerals forming part of the land, any more than on the price paid down in one sum for the out and out purchase of the minerals forming part of the land, is, I think, untenable.

As to the Pennsylvania cases, the Circuit Court of Appeals failed to notice *Denniston* v. *Haddock*, 200 Pa. St. 426, 428, where the court, after referring to the cases relied on by the Circuit Court of Appeals, said of mining leases:

> Whether it would be better to call such an instrument accurately what it certainly was at

> common law, a lease without impeachment of waste, or to endeavor to reconcile all the decisions by calling it a conditional sale, is not necessary at present to discuss. The point to be noted is that the rules applicable to sales are not to be applied indiscriminately to such instruments but each is to be construed like any other contract by its own terms.

Outside of the peculiar Pennsylvania cases, referred to by the Circuit Court of Appeals, the authorities are uniform that a mining lease is not a sale, and that the rents or royalties thereon are income. *United States* v. *Gratiot*, 14 Pet. 526, 538, 539; *Hyatt* v. *Vincennes Bank*, 113 U. S. 408, 416; *Raynolds* v. *Hanna*, 55 Fed. 783, 800, 801; *Tenn. Oil, Gas & Mineral Co.* v. *Brown*, 131 Fed. 696, 700; *Daly* v. *Beckett*, 24 Beav. 114; *Lacey* v. *Newcomb*, 95 Iowa, 287; *Hendrix* v. *McBeth*, 61 Ind. 473; *Comley* v. *Ford*, 65 W. Va. 429; *Eley's Appeal*, 103 Pa. St. 300; *McClintock* v. *Dana*, 106 *ib.* 386; *Shoemaker's Appeal*, *ib.* 392. In *Eley's Appeal*, *supra*, the court said (p. 306):

> The word "income" means the gain which accrues from property, labor or business. In its ordinary and popular meaning, it is strictly applicable to the periodical payments, in the nature of rent, which are usually made under coal and other mineral leases, and we have no doubt it was used in that sense by the testator.

The case of *United States* v. *Gratiot*, *supra*, is not cited by the Circuit Court of Appeals and is really decisive of the question.

It is said (219 Fed. 42) of some of these decisions that they arose under wills, and depended therefore merely on the intent of the testator, but there were in them no special indications of the testator's intention, and he was merely presumed to have meant by royalties in mining leases what everybody else meant thereby.

(*b*) Prior to the time the rights of the United States accrued the Supreme Court of Minnesota had decided, in *State* v. *Evans*, 99 Minn. 220, that a mining lease is not a sale but a lease, and that the royalties on it are true rents or profits accruing from the land, and this was affirmed in *Boeing* v. *Owsley*, 122 Minn. 190. That decision made a rule of property in Minnesota, and the Circuit Court of Appeals was bound to follow it.

Bucher v. *Cheshire R. R. Co.*, 125 U. S. 555, 583;

Clarke v. *Clarke*, 178 U. S. 186;

Abraham v. *Casey*, 179 U. S. 210, 218;

East Cent. E. M. Co. v. *Cent. Eureka Co.*, 204 U. S. 266, 272;

Kuhn v. *Fairmont Coal Co.*, 215 U. S. 349, 360;

Foster v. *Elk Ford Oil & Gas Co.*, 90 Fed. 178, 182;

York v. *Washburn*, 129 Fed. 564, 567;

Fretts v. *Shriver*, 181 Fed. 279.

It is contrary to all principle to have a mining lease of land in Minnesota called a sale if the question arise in the District Court for Minnesota, and a lease if it arise in a State court.

(c) It follows that the royalties or rents received by the respondent were income. The Circuit Court of Appeals refers as authority to cases where single sales of property have been held to be mere conversion of capital, but the judges who delivered those opinions were careful to state that the case of regular sales for a business are different. The rentals received on a lease of agricultural land or of a house necessarily represent, to some extent, a depletion of capital, and such leases may run so long that, unless replacement of capital be made, the property is worthless at the end of the term; but the rentals are nevertheless income. On this aspect of the case also *Mitchell* v. *Clark Iron Company, supra,* is decisive, for the court must have held in that case that the royalties on mining leases were income.

III.

The allowance as depreciation of all the receipts of royalties in excess of expenses was erroneous.

This follows necessarily from *Stratton's Independence, Limited,* v. *Howbert,* 231 U. S. 399, assuming that the respondents were "doing business," and had income. To say that they had income, but that, by deducting as depreciation the very items which constituted this income, they had none, is a *reductio ad absurdum.* There is no evidence in the record that the total amount of royalties received has any legitimate bearing on the amount of depletion of capital, figured either on a cost or on a value basis. The

opinion of the Circuit Court of Appeals went entirely on the ground that a mining lease is a mere sale on installments, and that everyone selling property on installments is entitled to deduct, *as depreciation*, the entire amount of the installment payments. The statement of such a proposition is its best answer, and, as to mining property at least, the case of *Stratton's Independence, Limited*, is decisive. Whatever the respondents may be entitled to deduct as depreciation, they are clearly not entitled, as matter of law, to deduct the entire amount of their net receipts.

IV.

It is respectfully submitted that the writs should issue as prayed.

JOHN W. DAVIS,
Solicitor General.

OCTOBER, 1915.

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In the Supreme Court of the United States.

OCTOBER TERM, 1915.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, Petitioner, *v.* SARGENT LAND COMPANY, A CORPORATION.	No. 707
FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, Petitioner, *v.* SUTTON LAND COMPANY, A CORPORATION.	No. 708
FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, Petitioner, *v.* KEARSARGE LAND COMPANY, A CORPORATION.	No. 709

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

MOTION TO ADVANCE.

Comes now the Solicitor General, appearing on behalf of the petitioner, and respectfully moves the court to advance the above-entitled causes

The companies paid the tax assessed and brought these actions to recover it. The district judge held that the companies were "doing business" within the meaning of the Corporation Tax Act. He held, however, that the rentals received were not income, but were return of capital, and rendered judgment for the full amount claimed by plaintiffs. The Circuit Court of Appeals affirmed the judgment (219 Fed. 31), holding (*a*) that the companies had no income since the payments were merely capital payments; (*b*) that a mining lease is not a lease at all, but a sale of the ore payable in installments, and hence the rentals are not income; (*c*) that the companies merely owned the right to the purchase price of the ore, as in the case of a person owning promissory notes payable in different years without interest and that the annual payments could not be called income; (*d*) that the companies were not "doing business" within the meaning of the act.

REASONS FOR THE ALLOWANCE OF THE WRIT.

1. The decision of the Court of Appeals that the plaintiffs were not "doing business" is contrary to the decision of this court in *Mitchell* v. *Clark Iron Co.*, 220 U. S. 107, 170.

2. The decision of the Court of Appeals that a mining lease is a sale on installments is contrary to the decision of the Supreme Court of Minnesota—the State where the land lay, where the leases were made and were to be performed—in *State* v. *Evans*, 99 Minn. 220 (Sept. 1906), and *Boeing* v. *Owsley*,

The decision whether a corporation is carrying on business within the meaning of the Corporation Tax Law must depend in each instance upon the particular facts before the court; no particular amount of business is required.

A corporation which has not reduced its activities to owning and holding property and the distribution of its avails, but maintains its organization for continued efforts in pursuit of profit and for such activities as are therein essential, is carrying on business within the meaning of the act.

Respondent corporations, besides receiving and distributing among their shareholders the royalties from a number of outstanding long term "mining leases," employed another company to inspect the lessees' operations and keep them to their contracts, made some mining explorations at expense on other parts of their properties, sold or leased other parcels and sold some timber, *held*, that they were carrying on business within the meaning of the Corporation Tax Law.

Quære: Whether this court, in determining whether royalties under mining leases are income subject to the Corporation Tax Law, is constrained to follow the decisions of the highest court of the State in which the leased property is situate holding that such royalties are rents and profits.

The "mining leases" involved in these cases, were not equivalent to sales of property; and the moneys paid by the lessees to the respondents were not converted capital, but rents or royalties, and as such were income, proper to be included in measuring their taxes under the Corporation Tax Law. *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103.

The depletion of a mine resulting from the removal of ore in the course of its operation is not a "depreciation of property" for which a deduction may be made under the Corporation Tax Law.

219 Fed. Rep. 31, reversed.

THE case is stated in the opinion.

Mr. Assistant Attorney General Wallace for petitioner: The respondents were "doing business" within the meaning of the Corporation Tax Act. The cases fall within *Mitchell* v. *Clark Iron Co.*, 220 U. S. 107, 170; not within *United States* v. *Emery, Bird, Thayer Realty Co.*, 237 U. S. 28. In the cases at bar the companies were

incorporated for the very purpose of getting, in the operation and management of mining leases, the advantage of a legal person over minors and undivided interests. The corporations supplied the main capital—the land. The lessees supplied the labor and, so to speak, the working capital. The product was divided between them. This arrangement constituted a community of interest between lessors and lessees and required the corporations to do what they did—namely, exercise a constant supervision over the business to see that they obtained their just royalties. This shows that the object of a mining lease is to divide up the mining business, the lessor furnishing most of the capital.

A mining lease is not a sale on installments, and the royalties thereon are income. See the full remarks of Lord Blackburn in *Coltness Iron Co.* v. *Black*, 6 App. Cas. 315, 335. As for the Pennsylvania cases relied on by the court below (219 Fed. Rep. 38, 39), see *Denniston* v. *Haddock*, 200 Pa. St. 426, 428; they oppose all the other authorities. Before the rights of the United States accrued, the Supreme Court of Minnesota had decided, in *State* v. *Evans*, 99 Minnesota, 220, that a mining lease is not a sale but a lease, and that the royalties on it are true rents or profits accruing from the land, and this was affirmed in *Boeing* v. *Owsley*, 122 Minnesota, 190, and in *Minnesota* v. *Royal Mineral Association*, 156 N. W. Rep. 128, notwithstanding the decision below. The decision in *State* v. *Evans* made a rule of property in Minnesota, and the Court of Appeals was bound to follow it.

The royalties or rentals, when received, constituted gross income of the lessors. *Mitchell* v. *Clark Iron Co.*, *supra*. Whether these "royalties" are called payments by installment of a debt, or conversion of capital from one form to another, they were, nevertheless, received by the companies during the taxing years from the business done by them with the advantages inherent in a corporate

organization. They were the gross income of the companies from such business, since gross income is nothing but gross money receipts or revenue. They are therefore within the very language of the act. *Anderson* v. *Forty-two Broadway Co.*, 239 U. S. 69. The distinction is plain between a casual conversion of capital, *Secretary of State* v. *Scoble* (1903), 1 K. B. 494 (1903) A. C. 299; *Stevens* v. *Hudson's Bay Co.*, 101 Law Times Rep. 96; *Gray* v. *Darlington*, 15 Wall. 63, 66, and a conversion occurring in the regular course of business. *Stratton's Independence, Ltd.*, v. *Howbert*, 231 U. S. 399, 414, 415; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 114.

"Depreciation" cannot be "allowed" under the act unless, and only to the extent that, actual deductions or payments have been made on account of it. Just as "income" must be an actual, not a hypothetical, receipt, so "outgo" must be an actual, not a hypothetical, payment. It seems clear that "depreciation," as defined by the act, is within the class "losses *actually* sustained within the year;" and it seems equally clear that a loss to be "*actually* sustained" must have caused some actual disservice or damage to the person concerned. *Baldwin Locomotive Works* v. *McCoach*, 215 Fed. Rep. 967, 969; 221 Fed. Rep. 59.

Depletion of capital cannot be deducted as "depreciation." The latter term does not naturally include the former. In the case of a mine the machinery, shafts, etc., depreciate, but we do not say that the deposit of mineral depreciates by being sold. The English decisions all seem to maintain, or, at least, countenance the view that depletion of capital cannot be deducted as depreciation. *Lee* v. *Neuchatel Asphalt Co.*, 41 Ch. Div. 1; *Wilmer* v. *McNamara & Co., Ltd.* (1895), 2 Ch. 245; *Coltness Iron Co.* v. *Black*, 6 App. Cas. 315; *Alianza Co.* v. *Bell* (1904), 2 K. B. 666 (1905), 1 K. B. 184 (1906), A. C. 18; *Kauri Timber Co., Ltd.*, v. *Commr. of Taxes* (1913), A. C. 771, 777. See

Boutwell on the direct and excise tax system of the United States, pp. 273, 274; *Stratton's Independence* v. *Howbert*, 207 Fed. Rep. 419, 421, 422; *Commonwealth* v. *Ocean Oil Co.*, 59 Pa. St. 61; *Commonwealth* v. *Penn Gas Coal Co.*, 62 Pa. St. 241; *Van Dyke* v. *Milwaukee*, 159 Wisconsin, 460. We know of no authority holding depletion of capital equivalent to "depreciation" other than the decision of the court below and that in the *Nipissing Mines Case*, 202 Fed. Rep. 803.

Mr. John R. Van Derlip, with whom *Mr. Burt F. Lum* and *Mr. Kenneth Taylor* were on the brief, for respondents.

The respondents were not corporations "organized for profit." The sole purpose of their organization was the liquidation of the assets contributed, in undivided portions, by the owners, with a view to the partition of the whole and to enable them to realize the money equivalent of their respective contributions, but with no view to dealing, speculating, trading, or gain. The act means that a corporation, to be subject to taxation, must be organized to make profit from the carrying on or doing of business. *Lewellyn* v. *Pittsburgh, B. & L. E. Ry. Co.*, 222 Fed. Rep. 177, 183, 184; *Smith* v. *Anderson*, L. R., 15 Ch. Div. 247. The words "organized for profit," do not merely distinguish between charitable corporations and all others. The suggestion that any corporation organized by private persons for their own advantage or interest is organized for profit is untenable. Such an interpretation is opposed to the common acceptation of the words, and renders them idle. For it is not sensibly conceivable that any persons would organize a corporation, unless it would be of some advantage to them. The tax is not a tax on incomes, nor on corporations which merely receive incomes from property. *Zonne* v. *Minneapolis Syndicate*, 220 U. S. 187; *McCoach* v. *Minehill &c. R. R. Co.*, 228 U. S. 295; *Flint* v. *Stone-Tracy Co.*, 220 U. S. 149, 152. The receipt of inter-

est, rent, or other income is simply a concomitant of property ownership. *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 625, 626. "Profit" in this act signifies the gain from a commercial or other active business, involving "ordinary and necessary expenses" in the way of rentals, salaries and other outgoes and obligations. *Gray* v. *Darlington*, 15 Wall. 63; *People* v. *Board of Supervisors*, 4 Hill, 20. If the words "organized for profit" be ignored, the act would apply to every corporation carrying on or doing business, which, concededly, it does not.

Respondents were not "carrying on or doing business" during the years for which the tax was assessed. There was no substantial activity other than the receipt of moneys payable to them under the outstanding mining contracts and the distribution of such moneys to their stockholders. It was only because the act was limited to corporations doing business that its constitutionality was sustained. *Flint* v. *Stone-Tracy Co., supra.*

In *Mitchell* v. *Clark Iron Co.*, 220 U. S. 107, 170, the question whether the Clark Iron Company was "doing business" within the meaning of the statute was not an issue. This court assumed that the company was continuing, after the passage and approval of the act, to make leases from time to time, an activity, which, if it existed, may be conceded to be doing business within the statute.

The amendment of the articles of incorporation in these cases conforms completely in its effect to the amendment made by the Minneapolis Syndicate in the *Zonne Case, supra*, and also in *Abrast Realty Co.* v. *Maxwell*, 206 Fed. Rep. 333; *s. c.*, 218 Fed. Rep. 457.

In every case the question is determined not by the power to act, but by the activities engaged in by the corporation. *Flint* v. *Stone-Tracy Co.*, 220 U. S. 107, 145, 151; *United States* v. *Emery, Bird, Thayer Realty Co.*, 237 U. S. 28, 32; *Minehill &c. R. R. Co.* v. *McCoach*, 192

Fed. Rep. 670, 672; *Public Service Ry. Co.* v. *Herold*, 227 Fed. Rep. 500; *State Line Co.* v. *Davis*, 228 Fed. Rep. 246, 249.

Owning and caring for property and division of the income from it is not "doing business." Business must be actually done. So far as concerns the mining property, the contracts disqualified respondents from "doing business." The business was all done by the lessees. The petty licenses to squatters and the two or three sales of burned timber to save its value from destruction were of course merely incidental and negligible. So were the sales of land, which were trivial, incidental to ownership and made under a contract antedating respondents' ownership. Sales, or receipts of principal, interest or rents, as incidents of ownership, are not doing business.

Since the receipts of money under the mining contracts represented merely a conversion of capital assets without gain or profit, they were not "gross income." Respondents took and held the legal title, subject to the outstanding contracts, pursuant to which they could receive, and anticipate receiving, nothing except the moneys which should become payable thereunder. Even if the contracts were not sales of the ore, it does not follow that the receipts were income. Counsel here distinguished English cases, and cited *Caldwell* v. *Fulton*, 31 Pa. St. 475; *Harlan* v. *Lehigh C. & N. Co.*, 35 Pa. St. 287; *Citizens' Gas Co.* v. *Whitney*, 232 Pa. St. 592, and many other Pennsylvania decisions, and *Hook* v. *Garfield Coal Co.*, 112 Iowa, 210; *Wilson* v. *Youst*, 43 W. Va. 826; *Selvey* v. *Grafton Coal Co.*, 72 W. Va. 680; *Manning* v. *Frazier*, 96 Illinois, 279. The contracts are analogous to executory contracts of sale. *Genet* v. *D. & H. Canal Co.*, 136 N. Y. 593; *Browning* v. *Boswell*, 215 Fed. Rep. 826; *Kansas Natural Gas Co.* v. *Board*, 75 Kansas, 335.

The decisions of the Minnesota Supreme Court on the nature of such "mining leases" are not binding as a rule of

property or otherwise. All the cases cited to the contrary concerned private disputes in most instances governed by local laws or rules of property, and in none of them was the construction of a federal statute involved. The law in question is a federal taxing law which under the Constitution must operate with uniformity to be valid, and in applying it the federal courts must follow their own judgment.

Gross income and gross receipts are different things. There is no tax unless there are net profits. *Flint* v. *Stone-Tracy Co.*, 220 U. S. 145. If the receipts from the leases were income there would be no distinction under the act between income and "property or invested capital."

That proceeds of sales of capital are not income, see: *Stevens* v. *Hudson's Bay Co.*, 101 L. T. Rep. 96; *Secretary of State for India* v. *Scoble*, 89 L. T. Rep. 1; *Baldwin Locomotive Works* v. *McCoach*, 215 Fed. Rep. 967, 969.

That is capital which is owned by a taxpayer at the time of the incidence of the tax, and to the extent of its value at that time, money into which the property is afterward converted, is not to be considered as income which can form the basis of taxation.

The respondents were entitled to deduct the amount of the royalties as "a reasonable allowance for depreciation of property," under the act. Omission to enter them in a depreciation account was not material, and the Commissioner's regulation to the contrary was an unlawful extension of the act. The question of depreciation was one of fact. *Bailey* v. *Railroad Company*, 106 U. S. 109. As a fact the capital value of the contracts, as it was when the act took effect, was diminished by the amount of the subsequent payments. This was "depreciation," under the act. See the Income Tax Law of September 8, 1916, §§ 10 and 12, 39 Stat. 756.

Stratton's Independence v. *Howbert* is consistent with the foregoing propositions.

MR. JUSTICE DAY delivered the opinion of the court.

These three cases were argued and submitted together and involve practically the same facts. Suits were brought by the corporations named in the United States District Court for the District of Minnesota against the Collector of Internal Revenue, to recover certain taxes, paid under protest, assessed under the Corporation Tax Law of 1909, 36 Stat. 11, 112, for the years 1909, 1910 and 1911. The judgments in the District Court were for the respondents (207 Fed. Rep. 423), which judgments were affirmed in the Circuit Court of Appeals. 219 Fed. Rep. 31.

In 1890, John S. Pillsbury, George A. Pillsbury and Charles A. Pillsbury, doing business together as John S. Pillsbury & Company, were the owners of large tracts of lands in northern Minnesota, which had been acquired for the timber and from which the timber had been cut, being valuable after such severance of the timber for the mineral deposits contained therein. In the year named, the Pillsburys entered into an arrangement with John M. Longyear and Russell M. Bennett, authorizing the latter two to explore the lands for iron deposits. In 1892, Longyear and Bennett having discovered valuable deposits of iron ore, a half interest in something over ten thousand acres of the lands was conveyed to them, the lands thereafter being owned by the Pillsburys, John, George and Charles, each an undivided sixth, and John M. Longyear and Russell M. Bennett each an undivided fourth. In the year 1901, the Pillsburys having died, these corporations were formed under the laws of Minnesota. In 1906, the ownership of these leased lands was vested in the three corporations named as respondents in the proceedings. As originally organized, the nature of the business was stated to be "the buying, owning, exploring and developing, leasing, improving, selling and dealing in, lands, tenements and hereditaments, and the doing of all things

necessary or incidental to the things above specified." In December, 1909, the articles of incorporation were amended to read as follows: "The general purpose of the corporation is to unite in one ownership the undivided fractional interests of its various stockholders in lands, tenements and hereditaments, and to own such property, and, for the convenience of its stockholders, to receive, and distribute to them, the proceeds of any disposition of such property at such times, in such amounts, and in such manner, as the board of directors may determine."

All of the mining leases, hereinafter mentioned, with the exception of a contract with the Van Buren Mining Company, were executed before the organization of the corporations. Each of these instruments provided that the owners of the property demised to the lessees, exclusively, all the lands covered by the descriptions for the purpose of exploring for, mining and removing the merchantable iron ore which might be found therein for and during the period named, usually fifty years. The lessees were given exclusive right to occupy and control the demised premises and to erect all necessary buildings, structures and improvements thereon. Right was reserved to the lessors to enter for the purpose of measuring the amount of ore mined and removed and making observations of the operations in the mines. The lessees agreed to pay, in most cases, twenty-five cents per ton for all ore mined and removed, and to make such payments monthly for ore mined and shipped during the preceding month. The lessees agreed to mine and ship a specified quantity of ore in each year, and, in default of this, to pay the lessors for the minimum amount specified, and take credit therefor and apply such sums upon ore mined and shipped thereafter in excess of such minimum. The lessees were to pay the taxes and to keep the property free from encumbrances and liens. Right was reserved to

terminate the contract upon the failure of the lessees to comply with the terms thereof.

The form of the leases is shown in Exhibits 15 and 16, which were not in the printed record, owing to their length, but copies of which, pursuant to stipulation, have been sent to this court. An examination of Exhibit 16 shows that the lessees had the right to terminate and surrender the lease by giving the lessors, or those having their estate in the premises, sixty days' written notice, and executing sufficient conveyances releasing all interest and right of the lessees in the premises with any improvements thereon, and surrendering the same in good order and condition, etc., and that thereupon all liability of the lessees to taxes subsequently assessed on the demised premises or for rent thereof thereafter to accrue, or royalty on ores therefrom except on account of ores removed, should cease and determine; the lessees to be liable for all ores removed from the premises not theretofore paid for, and to pay for the premises rent or royalty for the year in which termination should be made, or the portion thereof which should have expired, at the rate of $12,500.00 per annum.

Since their organization the corporations have disposed of certain lands and have also disposed of the stumpage on some timber lands. Certain parcels were rented and leased, and a village was allowed to use part of the land for schoolhouse purposes, as well as another part for a public park.

To insure the proper carrying on of the mining operations, the companies employed another corporation, engaged in engineering and inspection of ore properties, to provide supervision and inspection of the work upon the respondents' properties, for which the inspecting company was paid from month to month, as statements were rendered.

The companies were assessed upon their gross income,

for joint hearing on a day convenient to the court at the next term.

These are suits brought by the above-named respondents to recover taxes claimed to have been erroneously collected under the provisions of the Corporation-Tax Act. The question presented is whether corporations, lessors in mining leases, are liable to pay a corporation tax on the royalties or rents received therefrom, under the provisions of section 38 of the act of Congress of August 5, 1909, 36 Stat. 11, 112. The determination of the question by this court will control the disposition of a number of cases where taxes were collected under similar circumstances.

Opposing counsel concur in this motion.

JOHN W. DAVIS,
Solicitor General.

APRIL, 1916.

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